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IN THE

Supreme Court of the United States

PENNZOIL COMPANY AND SUBSIDIARIES,
Petitioner,

v.

DEPARTMENT OF REVENUE, STATE OF OREGON,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of the State of Oregon

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF THE *AMICUS CURIAE*

The Council On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[1] COST is a non-profit trade association organized in 1969 as an advisory committee to the Council of State Chambers of Commerce.[2] COST, which was separately

[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consents for the filing of this brief have been obtained from the Petitioner and Respondent and filed with the Clerk of the Court.

[2] COST was previously the Committee On State Taxation but changed its name to the Council On State Taxation by vote of its membership November 6, 2001.

incorporated on January 1, 1992, has a membership of over 540 multistate corporations involved in interstate and international commerce. COST's objective is to preserve and to promote equitable and nondiscriminatory state and local taxation of its members and all multi-jurisdictional business entities.

COST members' interest in this case is both specific and general: while some members may receive income from settlement of extraordinary tort litigation, like that at issue here, all members are interested in the Court's interpretation of Constitutional limits on a state's ability to tax a nondomiciliary corporation's income. This case presents the most blatant example to date of a state's ignoring the holding in *Allied-Signal, Inc. v. Director, N.J. Div. of Tax,* 504 U.S. 768 (1992). *Allied-Signal* prohibits states from taxing income which is derived from activities unrelated to the activities of the taxpayer in the taxing state In the parlance of state taxation, income is referred to as business or non-business income. Business income is apportioned among all of the states in which the taxpayer carries on a unitary business. Non-business income is taxed only by the state of the corporation's commercial domicile. So, in order to avoid being whipsawed, the business/non-business character of income must be fairly susceptible of definitive determination. COST's members are concerned that inconsistent treatment by the state of similar income and the lack of careful review of this treatment by this Court will lead to additional erosion of Constitutional protections and double taxation. While there may continue to be uncertainty in close cases, clear cases such as this one can define a zone of certainty.

COST submits this brief asking the Court to clarify that *Allied-Signal* "means what it says,"—that there are limits on a state's ability to tax extraterritorial income. Specifically, COST requests that the Court will enforce its own prohibition against taxing income that has no operational relation to the

taxpayer's activities in the state. *See Allied-Signal*, 504 U.S. 768; *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). Ten years after the decision in *Allied-Signal*, states are ignoring and have apparently forgotten its import in their continued attempts to erode Constitutional limitations.

SUMMARY OF THE ARGUMENT

The United States Constitution limits states' ability to tax income from outside their territorial boundaries. Generally, states may tax an apportioned part of a multijurisdictional taxpayer's total income if the income arises from a unitary business a part of which is conducted in the state. However, if the income is earned independent of the unitary business connected with the taxing state, states may tax an apportioned part of the income only if the thing giving rise to the income served an operational function in the taxpayer's business and was connected to the taxpayer's activities in the State. This Court's decision, in *Allied-Signal,* clearly established a prohibition against taxing non-unitary extraterritorial income with no operational relationship to the taxpayer's *in-state activities*. Even so, the Supreme Court of Oregon ignored *Allied-Signal* and imposed a tax on a tort settlement that had no operational function in the taxpayer's business and that had no connection to Oregon

As discussed in more detail in Petitioner's brief before this Court, Pennzoil Company ("Pennzoil" or "taxpayer") received settlement proceeds relating to a claim for tortious interference with a contract. When Pennzoil filed its return it classified the settlement proceeds as non-business income not subject to tax by Oregon. The Oregon Department of Revenue ("Department") recharacterized the settlement proceeds as business income and subjected an apportioned part of these proceeds to the Oregon (excise) tax. Pursuant to the standards set out in *Allied-Signal*, the Constitutional

inquiry is whether Pennzoil's income from the settlement of its tort claim had any operational relationship to Pennzoil's business activities in Oregon. The Oregon Supreme Court determined that the income was operationally related to Pennzoil's activities in Oregon by evaluating the tax consequences *as if* Pennzoil had successfully completed its contract and had actually received business income as a result. The Oregon Supreme Court substituted this hypothetical analysis instead of focusing on the true nature of the transaction, which was a failed attempt to purchase a block of stock. The Oregon Supreme Court relied on the idea that Pennzoil would have acquired new oil reserves for its petroleum processing business if the planned stock purchase had been successful, and that these oil reserves would have had an operational purpose. The court failed to evaluate the income in its true character—settlement of a tort claim arising from interference with an attempted stock purchase. Pennzoil never acquired oil reserves that could have served an operational purpose. The oil reserves were owned by another company and contributed to its business, not Pennzoil's. Further, without oil reserves there could be no connection between the income generated and the State. The Oregon Supreme Court missed the point when it concluded that, "acquisition of oil reserves is related—indeed is vitally important—to the continued blending and distribution of motor oil in Oregon." *Pennzoil Company and Subsidiaries v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001). There was no oil. There was only a tort committed outside the state to which Oregon had no claim. The court's fanciful conclusion cannot alter the fact that the income in question arose out of tortuous conduct by an actor who was not even the taxpayer and had absolutely no contact with Oregon. It is as if an innocent person on the way to a real estate closing had been killed in an automobile accident and the court had concluded that the proceeds of the wrongful death action are attributable to the real estate transaction. This case presents

an opportunity for the Court to validate and clarify the rule set out in *Allied-Signal*. Without review here, states will continue to ignore the Constitutional parameters on taxation of extraterritorial income.

ARGUMENT

I. The Commerce Clause of the United States Constitution, as interpreted by this Court in *Allied-Signal*, forbids a state to tax a corporation's income if that income is not derived from corporate activity a part of which occurs in the taxing state.

As a general principle, both the Commerce Clause and the Due Process Clause limit a state's ability to tax a nondomiciliary corporation's multi-state income. U.S. Const. art. I, § 8, cl. 3; amend. XIV, § 1. Consistent with these Constitutional limitations, a state's ability to tax income earned by a multistate business requires a "minimal connection" between the interstate activities of the corporation and the taxing state. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978)); *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954); *Allied-Signal*, 504 U.S. at 778. States are prohibited from taxing a nondomiciliary corporation's income, if that income is "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207, 224 (1980) (quoting *Mobil Oil*, 445 U.S. at 442).

As a result of these Constitutional limitations, states have adopted practical statutory rules for determining when income is subject to tax in each jurisdiction. States use the concept of "business income" to identify income that can be apportioned and taxed by each jurisdiction in which the

company earns income, and the concept of "non-business income" to identify income that is allocated to a single jurisdiction for tax purposes. These concepts have been statutorily captured in the Uniform Division of Income for Tax Purposes Act (UDITPA), which defines "business" and "non-business income".[3] UDITPA's definitions provide a practical approach for states to identify income taxable in each jurisdiction; however, the definitions are merely statutory and are applied differently than the Constitutional rules.[4]

The present matter involves a dispute at the state court level over the proper classification of a certain type of income (settlement of a tort claim) as either business or non-business income under the UDITPA definitions. The dispute also includes a Constitutional issue as to whether apportioning the income runs afoul of limits on a state's ability to subject income of a nondomiciliary business to apportionment. The question we encourage this Court to consider is whether Oregon's interpretation of the Constitutional limits (or lack thereof) is correct.

In defining the Constitutional limits on states' ability to tax income, this Court has developed two separate classes of income that may be subject to apportionment. First, income earned in a unitary business is apportionable. *See Mobil Oil*, 445 U.S. at 435. Recall, "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439. Second, income is apportionable, even

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[3] Oregon, like many states, has adopted UDITPA, which differentiates between business income, apportionable to various states, and non-business income, which must be allocated to one source state. *See* 7A U.L.A. 331 (1985); ORS 314.605 to 314.670 (1987).

[4] In *Allied-Signal*, this Court refused to equate the business/-non-business income tests of UDITPA with the Constitutional test for determining business income under the unitary business principle. *Allied-Signal*, 504 U.S. at 786-87.

in cases where the unitary principle is not involved, if it serves both an operational function within the business and is effectively connected to the state. *Container Corp.*, 463 U.S. at 180, n.19; *Allied-Signal*, 504 U.S. at 787.

The Court in *Allied-Signal*, "focuse[d] on the guidelines necessary to circumscribe the reach of the State's legitimate power to tax." *Id.* at 778. The Court analyzed the apportionability of a taxpayer's gain realized on the sale of stock the taxpayer held in an unrelated company. *Id.* at 774. Because the two entities were not unitary, the Court used the second test, as mentioned above, to determine the Constitutionality of subjecting the capital transaction to tax. Specifically, the Court held that the transaction must serve an operational function within the business, rather than an investment function, for a nondomiciliary state to be permitted to subject the income from that transaction to apportionment. *Id.* at 787.

Similarly, the instant case does not involve application of the unitary business principle. The case, however, does present the second test for apportionable income as set forth in *Allied-Signal.* The Constitutional rules are clear—Oregon has violated the Constitutional protections by taxing income from a tort settlement that is unrelated to Pennzoil's activities in Oregon and that has no operational function. Oregon's transgressions are explored below.

II. Oregon ignores this Court's ruling in *Allied-Signal* by taxing the settlement proceeds of a tort claim having no operational function and no connection to the State.

It remains the law that "'in order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to [those carried out in the taxing] State.'" *Allied-Signal*, 504 U.S. at 787 (citing *Exxon*, 447 U.S. at 223

(quoting *Mobil Oil*, 445 U.S. at 439)). Oregon, apparently, has chosen to ignore the principles set forth by this Court. In the instant case, Oregon has demonstrated that income earned outside the state, with no relationship to a taxpayer's in-state activities, will be subjected to tax.

A. Pennzoil's tort claim did not serve an operational function.

Where a state is trying to tax a nondomiciliary company's income from a capital transaction, and the unitary business issue is not implicated, the proper Constitutional inquiry is whether the transaction served an operational function in the taxpayer's business. The operational function distinction originated in *Container Corp.* and subsequently was affirmed in *Allied-Signal*. In *Container Corp.*, this Court reviewed the Constitutionality of California's worldwide combination tax scheme. *Container Corp.*, 463 U.S. 159 (1983). Although *Container* involved a unitary business determination, the Court pointed out that "capital transactions can serve either an investment function or an operational function." *Id.* at 180 n.19. In *Allied-Signal* this Court further clarified the meaning of the operational function test. In *Allied-Signal*, the Court considered the taxability of a gain on a capital transaction realized by Bendix Corporation on the sale of its stock in ASARCO, Inc., another company, which was not part of the unitary business of Bendix. *Allied-Signal*, 504 U.S. at 773. Because the payee and payor were not engaged in the same unitary business (and, in fact, were completely unrelated entities), the Court clarified that the two corporations need not be unitary in order for Bendix to be required to apportion the gain. *Id.* at 774, 787. Rather, "[w]hat is required instead is that the capital transaction [that produced the income] serve an operational rather than an investment function." *Id.* at 787, citing *Container Corp.*, 463 U.S. at 180, n.19.

In the instant case, the Oregon Supreme Court performed the operational function analysis but ignored Pennzoil's tort claim as the source of the income. Instead, Oregon assumed that *had* Pennzoil obtained oil reserves, those *reserves* would have had an operational relationship to the processing of oil which took place in the State. Oregon's analysis completely ignores what actually did happen, and relies instead upon the possibility that Pennzoil *might have had* access to oil reserves if the tort had not occurred. In imposing a Constitutional standard on a hypothetical and contingent fact pattern to determine an actual tax liability, the State exceeds what is Constitutionally permitted by this Court in *Allied-Signal*. Pennzoil did not own stock, and did not own oil reserves. It merely owned a claim against a tortfeasor that ultimately resulted in a settlement. While oil reserves *may* have ended up producing income that was operationally related, the tort settlement did not.

Use of a hypothetical "what could have happened" test is unworkable in the real life world requiring precise tax classification. Because of the tort committed against Pennzoil, the oil reserves, and the subsequent income, now belong to someone else. Under Oregon's hypothetical test, that income would never have existed—should the current owner exclude such income entirely from its tax base? The hypothetical scenarios are endless—perhaps Pennzoil would have foregone other purchases currently producing business income (and being taxed by Oregon) if the original stock purchase had been successful. The impossibility of classifying income based on "what could have happened" demonstrates why Due Process and Commerce Clause concerns mandate a concrete *and real* connection between the income to be taxed and 1) the taxpayer's business and 2) the taxpayer's activities in a taxing state. Without such a concrete connection, a hypothetical scenario is always available to support a tax imposition.

B. Pennzoil's tort claim was not related to its activities in the State.

In *Allied-Signal*, this Court rejected New Jersey's theory that "any business in the State, no matter how small or unprofitable, subjects all of a corporation's out-of-state income, no matter how discrete, to apportionment." *Id.* at 784. Today, this Court is presented with an opportunity to review Oregon's application of a theory that this Court has already rejected. Although the Oregon Supreme Court's decision does not expressly articulate the New Jersey theory, in practice, Oregon has effectively taken the same position. The attempted stock purchase, the ensuing tortious interference, and the resulting settlement, had no connection to Pennzoil's activity in the State, which was to operate a single facility to blend, package, and distribute motor oil. Nevertheless, the Oregon Supreme Court concluded that "acquisition of oil reserves is related—indeed is vitally important—to the continued blending and distribution of motor oil in Oregon." *Pennzoil Company and Subsidiaries v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001). Again, the Oregon court misses the point. No oil was acquired, there was no attempt to acquire oil. There was no actual ownership of stock that controlled the oil, there was only a failed attempt to acquire stock in a company that *may* have led to the acquisition of oil. Pennzoil's facility in the state had *nothing* to do with the subsequent litigation concerning the failed acquisition—the litigation was not controlled there; the case was not prosecuted there; no settlement talks occurred there—nothing. The case had *no* effect on the Pennzoil's operations in Oregon. Collapsing the potential into the actual in what is tantamount to a misplaced step-transaction doctrine, the Oregon Supreme Court is able to reach outside the State to tax that to which it has no Constitutional entitlement.[5]

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[5] *See Appeal of Chris-Craft Industries, Inc.*, 1968 Cal. Tax LEXIS 44 (Cal. St. Bd. Of Equal., Mar. 26, 1968). In *Chris-Craft*, the taxpayer purchased land with the intent to build a manufacturing plant on that site.

The Oregon Supreme Court decision relies, in part, on *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955). This Court, in *Corn Products*, addressed a taxpayer's purchase of corn futures to insure an adequate supply of raw materials to the company's business. Unlike *Corn Products*, where the taxpayer actually bought the corn futures, Pennzoil never actually acquired access to the oil reserves. Pennzoil was not even successful in buying the target company. Indeed, the essence of Pennzoil's tort claim is that it was prevented it from doing what Oregon now wants to tax as though complete. The *Corn Products* doctrine covers income earned while hedging a need for raw materials but cannot be stretched to cover a tort settlement for a failed transaction that *may* have ended up providing raw materials to the business. Under *Corn Products*, assets used directly in the taxpayer's business have an operational connection to the state. While true of raw materials purchased for the business' operations, it cannot be similarly said that this tort settlement has *any* connection to the State or the taxpayer's nominal oil processing activity there; thus, Oregon does not have the requisite connection to the income producing activity required by this Court. *See Allied-Signal*, 504 U.S. at 778

Instead, the taxpayer sold the property without even making use of the property. Despite the taxpayer's original intent, the California State Board of Equalization held that the property did not become part of the taxpayer's unitary business and never contributed to the taxpayer's unitary income. The instant case is analogous to the decision in *Chris-Craft* because although Pennzoil *may have* intended to obtain oil reserves with the purchase of the stock, Pennzoil did not purchase stock; accordingly any supposed oil reserves cannot be part of Pennzoil's operational income.

CONCLUSION

In the ten years since *Allied-Signal* was decided, states have persistently attempted to expand out of existence the "operationally related" rule set out therein. A reiteration of the protections offered by *Allied-Signal* is needed to protect taxpayers from the long arm of states reaching beyond their borders to tax extraterritorial income. *See Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000) (states may not tax extraterritorial values through unreasonable expense disallowance). For the reasons stated above, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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